Hastings Law Journal

Volume 47 | Issue 2 Article 4

1-1996

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Ariela Freed

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Recommended Citation

Ariela Freed, *Progress Versus Protectionism: The Double Taxation of Computer Software in Korea*, 47 HASTINGS L.J. 473 (1996).
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Notes

Progress versus Protectionism: The Double Taxation of Computer Software in Korea

by
ARIELA FREED*

In the wake of recent concessions made by the Republic of China to stave off U.S. trade sanctions and to ensure American copyright-based industries market access and intellectual property protection[1], it is easy to overlook the transgressions of a somewhat lesser-known player in the Asia/Pacific trade forum—the Republic of Korea. The current problems created by Korea's trade practices certainly do not approach the magnitude of those posed by China's. Nonetheless, an examination of Korea's policies over the past decade and a look at its more recent actions with respect to the importation and taxation of computer software reveal a pattern of protectionism no less disheartening from the perspective of copyright-based industries than the rampant piracy and closed markets of its larger Asian neighbor. As Korea continues to grow in economic stature in the world's marketplace,[2] its importation and taxation practices are likely to become increasingly

* J.D. Candidate 1996; B.A. 1991, University of California, Berkeley. I would like to thank Professor Jay Clemens and all others who provided invaluable assistance and encouragement in preparing this Note.

1. *See generally Press Briefing By U.S. Trade Representative Mickey Kantor On A U.S.-China Trade Agreement*, Fed. News Serv. (Fed. Information Systems Corp.), Feb. 26, 1995 (discussing important provisions of the agreement); Release from the Office of the Press Secretary, the White House, *Statement by the President* (Feb. 26, 1995) (China's work to eliminate trade practices that have cost American exporters over $1 billion per year will "mean thousands of jobs for Americans" in copyright-based industries).

2. Korea's rapid industrialization and increasing international prominence has led some authors to dub it "tomorrow's power house" and "Asia's next giant." Robert W. McGee & Yeomin Yoon, *Technical Flaws in the Application of the U.S. Antidumping Law: The Experience of U.S.—Korean Trade*, 15 U. PA. J. INT'L BUS. L. 259, 264 (Summer 1994) (citing Louis Kraar, *Korea: Tomorrow's Powerhouse*, FORTUNE, Aug. 15, 1988, at 75, 75 and ALICE H. AMSDEN, ASIA'S NEXT GIANT: SOUTH KOREA AND LATE INDUSTRIALIZATION (1989)).

problematic for United States software concerns, which in 1994 alone provided approximately $184 million in exports to Korea.[3] In fact, for the United States, Korea may be a pot just beginning to boil. A February, 1995 article in the Wall Street Journal noted that trade disputes between Washington and Seoul have simmered for almost a year, and could conclude with sanctions under United States law.[4] Among the principal issues at the heart of these disputes is Korea's use of nontariff barriers to effectively reduce the importation of American-made computer software.[5]

This Note addresses transaction-based customs valuation and the imposition of withholding taxes, two key measures that have been used by the Korean government to erect barriers to market access for foreign makers of computer software products.[6] Part I of the Note provides an overview of the Korean government's trade record for the past ten years, contrasting its repeated promises to open domestic markets and reduce protectionism with concrete examples of its efforts to discourage the importation of foreign goods and investment. Part II discusses the application of Korea's unspoken protectionist policies to the importation of computer software. Specifically, Part II discusses Korea's practice of including the value of software data content in the calculation of customs duties. The author argues that this practice is contrary to prevailing international standards for software valuation and creates a substantial disincentive for foreign software manufacturers seeking to market their products in Korea. Part III of the Note examines the Korean taxing authority's policy of levying

3. U.S. Computer Software, Cigarettes, and Dogfood, 12 Int'l Trade Rep. (BNA) No. 29 at 1246 (July 19, 1995).

4. 4. Steve Glain, *U.S. Trade Dispute Simmers with Korea*, WALL ST. J., Feb. 6, 1995, at A8 [hereinafter Glain, *U.S. Trade Dispute Simmers with Korea*]; *see also* James Srodes, *Wall Street View: Kantor Scales the Trade Wall*, SUNDAY TELEGRAPH, Feb. 12, 1995, at 5 (according to U.S. Trade Representative Mickey Kantor, trade relations between the United States and Korea "were at their lowest ebb in years" due to disputes over market access for American farm, software, and telecoms products). Section 301 of the Trade Act of 1974, as amended by the Uruguay Round, allows the United States to institute retaliatory measures against countries that engage in discriminatory and unreasonable trade practices. 19 U.S.C. § 2411.

5. Glain, *U.S. Trade Dispute Simmers with Korea*, *supra* note 4; Srodes, *supra* note 4; *see also* Sally Gelston, *USTR Announces Watch Lists*, 17 E. Asian Exec. Rep. (Int'l Exec. Rep., Ltd.) No. 4, at 4 (April 15, 1995) (listing discriminatory customs valuation practices and software piracy among the factors supporting Korea's placement on the USTR's priority watch list); *USTR Announcement on Foreign Government Procurement (Title VII) and Intellectual Property Protection (Special 301), Executive Office of the President, Office of the United States Trade Representative*, 12 Int'l Trade Rep. (BNA) No. 18, at 791, 795 (May 3, 1995) (same).

6. For a thorough analysis of protectionist applications of U.S. law to imports of Korean goods, see McGee & Yoon, *supra* note 2. The article explains that nontariff barriers to trade between the United States and Korea by no means exclusively affect the sale of American products in Korea, but may be inherent in our own policies and practices as well.

withholding taxes on the revenue derived from certain software transactions, including sales of pre-packaged, "off the shelf" products, local access network ("LAN") transactions, and site licensing, thereby creating a second disincentive for foreign software manufacturers. Part III also examines the current debate within the United States over the proper tax characterization of such revenue and concludes that the imposition of withholding taxes by both the U.S. Internal Revenue Service and the Korean National Tax Administration is inappropriate. Lastly, Part IV discusses the measures which the Korean government should take to bring its customs valuation and taxation policies in line with international standards, and describes recent efforts by U.S. officials and business leaders to address the software industry's concerns in Korea.

I. Korea's Trade Record

The World Trade Organization ("WTO") was created on January 1, 1995 to adjudicate disputes and enforce the General Agreement on Tariffs and Trade ("GATT"). According to the agreement establishing the WTO, international trade "should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services."[7] The GATT was designed to promote these objectives by substantially reducing tariffs, creating uniform rules for the valuation of imported goods, and eliminating nontariff trade barriers and discriminatory and protectionist practices in international trade.[8] Indeed, the GATT is touted as an embodiment of the principles of free market economics, insofar as contracting parties commit to open their markets to foreign imports and investment, and to protect intellectual property rights of foreign nationals.[9]

7. Agreement Establishing the World Trade Organization, reprinted in OFFICE OF THE U.S. TRADE REPRESENTATIVE, EXECUTIVE OFFICE OF THE PRESIDENT, FINAL ACT EMBODYING THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: GENERAL AGREEMENT ON TARIFFS AND TRADE 9 (April 15, 1994) [hereinafter GATT].

8. *See id.* The Agreement on Implementation of Article VII of GATT, which addresses valuation of goods for customs purposes, was negotiated because of overall dissatisfaction with arbitrary and protective measures used in many countries as nontariff barriers to international trade. *See* Dept. of the Treasury, U.S. Customs Service, *Statement of Administrative Action, in* CUSTOMS VALUATION UNDER THE TRADE AGREEMENTS ACT OF 1979, at 68 (Oct. 1981). The Agreement created international rules for customs valuation that promote uniformity, fairness and neutrality and eliminate the use of nontariff protective measures by contracting parties to GATT. *Id.*

9. Helen Cooper & John Harwood, *The Vote on GATT—The Rules Change: Major Shifts in Trade are Ensured as GATT Wins U.S. Approval*, WALL ST. J., Dec. 2, 1994, at A1.

The Republic of Korea is a signatory to the GATT, as finalized in the Uruguay Round of Multilateral Trade Negotiations in April of 1994 (it was also a signatory to the original 1947 GATT).[10] Moreover, Korea's former trade minister, Kim Chul Su, was a contender for the post of director general of the WTO.[11] By ratifying GATT and the agreement establishing the WTO, Korea has pledged to uphold and abide by the free market principles upon which these accords were founded. This commitment is, on its face, consistent with the Korean government's trade stance over the past decade, when it repeatedly voiced its desire to liberalize its trade policies and facilitate the flow of goods into the country. For instance, in 1991 the Korean government launched a "charm offensive" of speeches, newspaper articles, and luncheons to convince its trading partners (of whom the U.S. is the largest[12]) of its commitment to open its domestic markets to foreign trade.[13] Claiming they had a "new attitude" toward international trade due to the restructuring of the Korean cabinet, top trade officials stated that they were attempting to re-educate those working-level officials who determined which products and services could be imported into Korea in conformity with the government's more liberal trade policies.[14] Similarly, in March 1994, Seung-Soo Han, the Korean Ambassador to the United States, stressed Korea's "new open-door policy" in a letter to the editor of the Wall Street Journal.[15] According to Han, Korea had become a "seasoned player" in international trade with "an understanding that national economies are becoming increasingly interdependent and that protectionism carries a high

10. HOUSE COMMS. ON INT'L RELATIONS & WAYS AND MEANS, U.S. SEN. COMMS. ON FOREIGN RELATIONS & FINANCE, 104TH CONG., 1ST SESS., COUNTRY REPORTS ON ECONOMIC POLICY AND TRADE PRACTICES 66, 68 (Joint Comm. Print Feb. 1995) [hereinafter 1995 COUNTRY REPORTS].

11. Glain, *U.S. Trade Dispute Simmers with Korea*, *supra* note 4.

12. McGee & Yoon, *supra* note 2, at 264. Korea is the United States' eighth largest trading partner. *Id.*

13. Damon Darlin, *Koreans Indicate a New Willingness to Open Up Trade*, WALL ST. J., Mar. 18, 1991, at A9J [hereinafter Darlin, *Koreans Indicate a New Willingness to Open Up Trade*]; *see also* Damon Darlin, *Closing Door: South Korea Regresses on Opening Markets, Trade Partners Say*, WALL ST. J., June 12, 1990, at A1 [hereinafter Darlin, *Closing Door*] ("Korea has promised repeatedly to open its markets to imports and to protect the intellectual property rights of foreign companies.").

14. Darlin, *Koreans Indicate a New Willingness to Open Up Trade*, *supra* note 13. As of 1993, these efforts had not met with much success. *See* Steve Glain, *South Korea's Cutting Edge is Dulled: Many Blame Overprotective, Autocratic Bureaucrats*, WALL ST. J., Aug. 10, 1993, at A10 [hereinafter Glain, *South Korea's Cutting Edge is Dulled*] (Korea's civil servants continued to follow the protectionist regime of past autocrats despite the government's efforts at change).

15. Seung-Soo Han, *Letters to the Editor: South Korea's New Open Door Policy*, WALL ST. J., Mar. 14, 1994, at A15.

cost."[16] In accord with this understanding, Han stated that Korea was "liberalizing [its] markets and expanding [its] international cooperation."[17] Han acknowledged Korea's dependence upon foreign investment and technology transfers for its continued economic growth, and claimed that Korea was eager to match its skilled work force and manufacturing capabilities with American high technology.[18]

An analysis of Korea's trade practices over the past ten years reveals, however, that the Korean government has been saying one thing and doing another. While the government engaged in a consistent campaign to curry favor with the United States and other trading partners by promising to open up its domestic markets on the official level, it engaged in a pattern of conduct designed to do just the opposite—to erect tariff and nontariff barriers to the importation of goods and technology, to protect its domestic industries from the threat of competition, and to counterbalance the economic strain of lagging exports.[19] Moreover, Korea has been getting away with this conduct be-

16. *Id.*

17. *Id. See also* U.S. SEN. COMMS. ON FOREIGN RELATIONS & FINANCE, HOUSE COMMS. ON FOREIGN AFFAIRS & WAYS AND MEANS, 103D CONG., 2D SESS., COUNTRY REPORTS ON ECONOMIC POLICY AND TRADE PRACTICES 68, 69 (Joint Comm. Print Feb. 1994) [hereinafter 1994 COUNTRY REPORTS] (Korea's five year plan, released, in 1993 "promises a 'new Korea' of liberalized domestic and international policies").

18. Han, *supra* note 15.

19. *Submission of the International Anticounterfeiting Coalition, Inc. to the Office of the United States Trade Representative Concerning Intellectual Property Rights Protection*, at 35 (Feb. 1995) [hereinafter *IACC Special 301 Submission*]; Information Technology Association of America, *Special 301 Submission Relative to Korea*, at 2 (Feb. 1995) (submitted to the Office of the United States Trade Representative) [hereinafter *ITAA Special 301 Submission*]; Wang & Wang, *Playing Hardball with Software: Korea's Shakedown of U.S. Software Producers*, at 2-3 (Feb. 1995) (submitted to the Office of the United States Trade Representative) [hereinafter *Wang & Wang Brief*] (The author contributed to the drafting of the Korea sections of the IACC and ITAA Special 301 Submissions, and the Wang & Wang Brief. Accordingly, some language may be replicated within the aforementioned documents and this Note. All materials are on file with the HASTINGS LAW JOURNAL.). *See also* 1995 COUNTRY REPORTS, *supra* note 10 (the Korean government's economic policies have emphasized domestic protectionism and "[r]estrictions on foreign participation in the economy through trade and investment have been common."); *Prepared Testimony of the Honorable Charlene Barshefsky, Deputy U.S. Trade Representative, Before the House Subcommittees on Asia and the Pacific and on International Economic Policy and Trade of the House Committee on International Relations*, Fed. News Serv. (Fed. Information Systems Corp.), Feb. 2, 1995 ("While formal barriers to imports have fallen, Korea has raised new, more subtle barriers that effectively prevent the liberalization envisioned under the major trade policy initiatives of the late 1980s.").

The Wall Street Journal also reported in 1990 that foreign executives and trade officials felt dismayed in observing that the Korean government was "backtracking" on promises to open domestic markets. Darlin, *Closing Door*, *supra* note 13. While there were some signs of liberalization, Gilles Anouil, the ambassador to Korea for the Commission of the European Community ("EC"), stated, "when [the Koreans] open a door, sometimes they close another." *Id.* Peter G. Frederick, the counselor for commercial affairs at

cause the countries hardest hit by Korea's tactics—including the United States—believe that pressuring the Korean government will only further delay reform.[20] As a result, Korea maintains one of the most protected economies in Asia[21], while enjoying the fruits of rapid growth and the comparatively wide-open markets of its trading partners.[22] This is precisely the type of discrimination and protectionism that GATT and the WTO are designed to abolish, and that Korea committed to prevent as a party to these agreements.

According to an official in the U.S. Secretary of State's office, most trade barriers erected by the Korean government are in areas where the country's domestic industry is weak and unable to effectively compete with foreign producers.[23] Other factors, such as the Korean public's reputed xenophobia and the unwillingness of many

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the U.S. Embassy, voiced the U.S.'s concern over this "pattern of activity" by the Korean government. *Id.*

20. Darlin, *Closing Door*, *supra* note 13 (quoting a U.S. State Dept. official who stated, "We are still trying to get them to implement prior agreements, and taking on any more changes might overload the [Korean] system."). It is also possible that the United States' desire to maintain favorable political relations with the Republic of Korea, due to its strategic position with respect to North Korea, has affected the American government's decision not to apply undue pressure in the area of international trade.

21. *IACC Special 301 Submission*, *supra* note 19, at 35; *ITAA Special 301 Submission*, *supra* note 19, at 2; *Wang & Wang Brief*, *supra* note 19, at 3. *See also* Robert Keatley, *World Economy: U.S. Tests Way to Solve Trade Disputes With Seoul, Progressing Little By Little*, WALL ST. J., July 15, 1994, at A6 ("South Korea began the [Dialogue for Economic Cooperation] process with one of Asia's most protected economies; it's unclear just how different it is today."); 1995 COUNTRY REPORTS, *supra* note 10, at 67 ("The South Korean Government's economic policies have traditionally emphasized rapid export-led development and the protection of domestic industries. Government intervention in the economy to promote these objectives has been pervasive throughout the post-Korean war era.").

22. *IACC Special 301 Submission*, *supra* note 19, at 35; *ITAA Special 301 Submission*, *supra* note 19, at 2; *Wang & Wang Brief*, *supra* note 19, at 3. According to the U.S. Department of State, between 1986 and 1991 Korea saw "double digit real growth." 1994 COUNTRY REPORTS, *supra* note 17, at 68. In 1991, the Wall Street Journal reported that Korea's GNP was expected to grow more than 9%, which would make it the fastest growing economy in Asia, and possibly the world. Damon Darlin, *South Korea Tries to Slow Down its Economy as Inflation Increases*, WALL ST. J., Sept. 16, 1991, at A9E [hereinafter Darlin, *South Korea Tries to Slow Down its Economy as Inflation Increases*]. In 1992, Korea's GNP rose only 4.7%, 1994 COUNTRY REPORTS, *supra* note 10, at 68, but it was still the twelfth largest exporting country in the world, with approximately U.S. $80 billion in exports, Y.S. CHANG, KOREAN PATENT AND TRADEMARK LICENSING 1994 25 (1994). Economic growth accelerated again in mid-1993, 1995 COUNTRY REPORTS, *supra* note 10, at 67, and in 1994, the Korean Ambassador to the U.S. reported that Korea was among the world's 15 largest economies, Han, *supra* note 15.

23. Telephone Interview with Jim Zumwalt, Special Assistant to Assistant Secretary of State Dan Terrullo (Jan. 4, 1995). *See also* Antonio Mendoza, *Promoting the Transfer of U.S. Technology Across National Borders: The Enemy Within*, 20 N.C. J. INT'L LAW & COM. REG. 97, 97 n.14 (Fall 1994) (listing increasing financial and economic stability, expanding the domestic technology base, increasing employment, and protecting infant industries among the goals developing countries attempt to promote via trade regulation).

bureaucrats to implement liberal policies decreed by their more open-minded superiors for fear that changes will harm their careers, may also result in protectionist practices.[24] Notable examples of the Korean government's efforts to reduce foreign imports and protect its domestic markets are as follows:

(1) In early 1994, Korean customs officials seized a shipment of American-made sausages valued at approximately U.S. $1.5 million. The officials claimed these sausages were incorrectly classified over the previous four years as goods with a 90-day expiration period, when they should have been allowed only a 30-day expiration period (conveniently, the approximate amount of time it took for the sausages to reach Korea and undergo its lengthy customs process).[25] The sausages were declared illegal and were quarantined for months on the docks of Pusan.[26] A spokesman for Korean Importers of American Sausages, a trade organization, indicated that importers had complied with all documentation requirements for the previous four years, and that nothing changed until the Korean officials' sudden seizure of the shipment.[27] Both the importers and U.S. trade officials believed that the seizure and new shelf-life restrictions, "which came without warning," were a nontariff trade barrier erected by the Korean government to thwart importation in an expanding market (since 1990, Korea had imported approximately U.S. $7.5 million in sausages, primarily from the U.S.).[28]

24. Keatley, *supra* note 21. *See also* 1994 COUNTRY REPORTS, *supra* note 17, at 69 ("the bureaucracy can and often does frustrate efforts to implement change."); Glain, *South Korea's Cutting Edge is Dulled*, *supra* note 14 ("[A] big obstacle [to change] is a fear of foreign influences rooted in Korea's long history"). The Korean government has also been reluctant to reform because of considerations of national pride and politics. *See* James R. Schiffman, *U.S. and South Korea Bicker Over Trade*, WALL ST. J., Nov. 7, 1985, at A1 (quoting one Korean official as stating, "We can't afford to look like we are kneeling to U.S. pressure. That is the last thing we could do politically at home.").

25. Steve Glain, *From Sausages to Autos, U.S. Products Still Face Trade Hurdles in South Korea*, WALL ST. J., May 31, 1994, at A13 [hereinafter Glain, *From Sausages to Autos*]; *see also U.S.-Korea Talks Called 'Constructive'; Some Questions Raised, U.S. Official Says*, 11 Int'l Trade Rep. (BNA) No. 26, at 1039 (June 29, 1994) (indicating that the issue of "prohibitively short" sausage shelf-life requirements was raised with the Korean government in bilateral trade talks in June 1994). A similar incident occurred in 1992 with a shipment of Mars Snickers chocolate bars and Skittles candy worth $250,000. Glain, *South Korea's Cutting Edge is Dulled*, *supra* note 14. The Ministry of Health and Social Services in Korea claimed the goods failed to comply with new guidelines concerning quarantine certification. *Id.* In fact, Mars, Inc. never even knew about the guidelines because they had never been made public. *Id.*

26. Glain, *From Sausages to Autos*, *supra* note 25.

27. *Id.*

28. *Id.* The Korean government recently returned the shelf-life restriction on sausages to 90 days in response to U.S. industry pressure. Glain, *U.S. Trade Dispute Simmers with Korea*, *supra* note 4. However, problems with shelf-life requirements for other imported meat products have developed. United States meat exporters apparently object to

(2) In June of 1993, Korean governmental officials arrested seven representatives of the Amway Corporation and Sunrider International without warning for allegedly engaging in illegal pyramid schemes.[29] Amway and Sunrider are companies that specialize in commission-based door-to-door sales of household goods and herbal products.[30] The officials claimed that these door-to-door direct-sales practices were violative of the newly revised Door-to-Door Sales Act because they were geared toward generating large profits in a short period of time, after which the direct sales companies would leave the country.[31] The officials also complained that such practices were poisoning the Korean public's work ethic and damaging domestic industry by moving people away from more traditional, production-oriented jobs.[32] Although the Korean government released two of Amway's employees eight days after they were incarcerated, it detained the remaining five company representatives without bail for a considerably longer period of time, until the U.S. embassy succeeded in obtaining their release.[33] Not surprisingly, the government's sudden crackdown on Amway and Sunrider came at a time when the companies had seen a "phenomenal" increase in sales in Korea—up to approximately U.S. $1 billion in 1992, with a sales force of more than 100,000.[34]

(3) In 1990, the Korean government, concerned about lagging exports and skyrocketing imports, began an anti-import campaign that "made life difficult for importers."[35] One example of the Korean officials' measures was "the case of [the] imported pecans."[36] Although it is legal to import pecans into Korea, customs officials blocked shipments of the nuts claiming they were infested with coddling moths—an insect scientifically established *not* to live in pecans.[37] Despite this

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the Korean practice of determining shelf life on a product by product basis, rather than following the customary practice of relying on manufacturers' standards. *U.S. -Korea Frictions Continue Over Telecom, Meat Trade Issues*, 12 Int'l Trade Rep. (BNA) No. 11, at 493, 494-95 (Mar. 15, 1995). The United States believes Korea's policies are "arbitrary and trade-prohibitive." *Id.* at 495.

29. Steve Glain, *South Koreans Charge, Release Amway Agents*, WALL ST. J., July 8, 1993, at A9 [hereinafter Glain, *South Koreans Charge, Release Away Agents*]; Glain, *South Korea's Cutting Edge is Dulled*, *supra* note 14.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*; Time W. Ferguson, *Business World: Citizen Capitalism and 'Door to Door' Exports*, WALL ST. J., Aug. 31, 1993, at A11.

34. Ferguson, *supra* note 33. Korea's direct sales law is being revised by legislators in response to Amway's heavy lobbying efforts. Glain, *U.S. Dispute Simmers With Korea*, *supra* note 4.

35. *See* Darlin, *South Korea Tries to Slow Down its Economy as Inflation Increases*, *supra* note 22.

36. Darlin, *Koreans Indicate a New Willingness To Open Up Trade*, *supra* note 13.

37. *Id.*

scientific evidence, it took several members of Congress, the U.S. cabinet, and the American Embassy over a year to resolve the issue.[38]

(4) In 1990 the Korean government told Kia Motor Company, a Korean affiliate of Ford, to stop importing Mercury Sables because "Korea was importing too many foreign cars."[39] Shortly thereafter, the Korean government announced an increase in the number of subway bonds new car buyers were required to purchase, conspicuously making the amount for buyers of foreign autos greater than for buyers of domestic autos.[40] It also began ordering audits of drivers of imported cars, and tightening such cars' exhaust test requirements.[41] These actions were inconsistent with Korea's promise to open its domestic automobile market in 1987.[42] According to the Wall Street Journal, Korea's harassment of foreign car owners was part of a greater campaign against foreign products that the Korean government believed were damaging to its domestic market.[43]

(5) Additional examples of Korea's campaign against foreign goods in 1990, despite its purported open-markets trade policy, include the government's imposition of high taxes and tariffs on items such as Scotch, forcing up its resale price and making it "the most expensive in the industrialized world";[44] its expansive classification of luxury items (the importation of which was especially discouraged) to encompass such non-luxury goods as Tupperware;[45] and its failure to promptly approve applications of foreign banks desiring to join the Korean ATM network (for domestic banks, such as Donghwa Bank, approval was issued within two weeks, but foreign banks such as Citibank were forced to wait substantially longer).[46]

38. *Id.*

39. Darlin, *Closing Door*, *supra* note 13.

40. *Id.*

41. *Id.*

42. *Id.* In 1993, the Wall Street Journal called Korea's car market "the most protected in the world." Glain, *South Korea's Cutting Edge is Dulled*, *supra* note 14.

43. Darlin, *Closing Door*, *supra* note 13. Another measure which has proved particularly damaging to foreign car makers is Korea's import diversification policy, which requires importers to cut back on imports from a given country and diversify their purchases if the government decides that the volume of imports from that country is too high. Telephone Interview with Jim Zumwalt, *supra* note 23. While this policy has affected American companies to a limited extent (particularly those companies that route their imports through Japan), it is primarily geared toward Japanese car makers, and has proved to be a formidable nontariff trade barrier. *Id.* Japan is currently pressuring Korea to discontinue this policy on the ground that it violates the GATT and WTO Agreement. *Id.*

44. Darlin, *Closing Door*, *supra* note 13.

45. *Id.* *See also* 1994 COUNTRY REPORTS, *supra* note 17, at 71: "Most Koreans have been taught that imports are, by definition, luxury goods and somehow unpatriotic." The Korean government has targeted consumer imports with regular "frugality campaigns" to discourage their purchase. *Id.*

46. Darlin, *Closing Door*, *supra* note 13.

As these examples indicate, the Korean government has engaged in a consistent practice of utilizing nontariff measures—including the imposition of criminal sanctions, apparent in the Amway incident—to discourage foreign imports, particularly those it fears will adversely affect its domestic markets, economic growth, or cultural and societal values. Korea has persisted in claiming it wants to open its markets and do away with its protectionist policies, but has done the opposite for years,[47] in direct contravention of its obligations under GATT and the WTO Agreement.

II. Customs Valuation of Computer Software

A. Korea's Transaction—Based Valuation Policy

Korea's practice of relying upon nontariff measures to effectuate its protectionist trade policies is particularly apparent in the steps it has taken to dampen the importation of computer software[48], a key U.S. export.[49] One of Korea's most damaging measures was changing its policy with respect to the valuation of software for customs purposes from the widely accepted international standard of charging duties only on software "carrier media" (e.g., the diskette or magnetic tape upon which software is stored), to the practice of charging duties on the full transaction value of the software media *and* its data content.[50]

47. As the director of one trading company said, "The Koreans say 'You can, you can,' [but] [t]he reality is, 'You can't, you can't.'" Schiffman, *supra* note 24 (quoting Jack Dodds, managing director of Woodward & Dickerson Far East Ltd.).

48. The use of customs valuation procedures as a nontariff barrier to the importation of computer software is not unique to Korea. For an illuminating study of this problem in Japan, see Dario Robertson, *Customs Treatment of Software: The Duty-Free Dilemma*, 7 E. Asian Exec. Rep. (E. Asian Exec. Rep., Inc.) No. 8, at 7 (Aug. 15, 1985).

49. Copyright-based industries, including the software industry, are major players in the United States economy. *See* Stephen E. Siwek & Harold Furchtgott-Roth, Economists Incorporated, *Copyright Industries in the U.S. Economy: 1977-1993* (Jan. 1995) (copyright industries are among the fastest growing commercial businesses in the U.S.) (on file with THE HASTINGS LAW JOURNAL); *Press Briefing By U.S. Trade Representative Mickey Kantor On A U.S.-China Trade Agreement*, *supra* note 1 (computer software is among the fastest-growing and most competitive domestic industries). In 1993 alone, core copyright industries contributed approximately $238.6 billion to the U.S. economy, accounting for 3.74% of the Gross Domestic Product. Siwek & Furchtgott-Roth, *supra*. They also employed over 5.7 million people, comprising approximately 4.8% of the U.S. workforce. *Id.* Software industry leaders have stated that their growth, including their ability to increase domestic employment, is "dependent on [their] ability to export." *Unofficial Transcript of Select Revenue Measures Hearing, Part III*, 93 TAX NOTES TODAY, June 30, 1993, *available in* LEXIS, Legis Library, TNT File (Statement of James Abrahamson, Chairman of the Board of Oracle Corp.). In 1994, U.S. software makers exported $184 million in products to Korea. *See supra.*

50. *See generally* International Intellectual Property Alliance, *1995 Special 301 Recommendations and Estimated Trade Losses Due to Piracy*, at 50 (Feb. 13, 1995) (submitted

In 1984, the GATT Committee on Customs Valuation issued a separate ruling (Decision 4.1) to address the issue of media versus transaction-based valuation, recognizing "the unique situation" software posed in interpreting the Agreement on Implementation of Article VII of GATT.[51] This move came in response to a ruling request by the United States in 1982, proposing that Parties to the GATT agree that the information component of software is nondutiable for customs purposes.[52] The Committee endorsed this position exclusively in its proposed decision issued in January of 1983. It subsequently modified the ruling, however, in response to a request by the European Community to state that taxation of the full transaction value of software is also acceptable.[53]

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to the Office of the United States Trade Representative) (hereinafter "*IIPA Submission*") [The author also assisted in the drafting of the Korea section of the IIPA Submission, which is on file with the HASTINGS LAW JOURNAL.]; *ITAA Special 301 Submission*, *supra* note 19, at 2; *Wang & Wang Brief*, *supra* note 19, at 4; *IACC Special 301 Submission*, *supra* note 19, at 2. Transaction value is defined under the GATT as "the price actually paid or payable for the goods when sold for export to the country of importation . . . ." *Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994*, *in* GATT, *supra* note 7, at 172.

Perhaps the primary reason for Korea's discriminatory treatment of imported software is the government's desire to protect its burgeoning domestic software industry from foreign competition. In addition, software products, particularly high end items, are a lucrative source of tax revenue. *See* Michael E. Roll, Nissho Iwai American Corp. v. United States: *Customs Appraisement and Middleman Pricing Under Section 402 of the Tariff Act of 1930*, 17 FORDHAM INTL. L. J. 190, 198-99 (1993) (prior to the Tokyo Round of Multilateral Trade Negotiations, the calculation of customs value was frequently used by countries to generate increased revenue and protect domestic industries); John Borking, *Import Duties on the Value of Software from Non-EEC Countries*, COMPUTER LAW & PRACTICE NO. 1, at 10, 14 (Sept./Oct. 1985) (observing that some developing countries may use high customs duties to protect their domestic software industries).

51. U.S. Valuation of Imported Carrier Media Bearing Data or Instructions for Use in Data Processing Equipment, 19 Cust. B. & Dec. 299, T.D. 85-124 (July 8, 1985) (also published in the Federal Register, 50 F.R. 30558-30559). Article VII of GATT addresses acceptable methods of computing the transaction value of goods for customs purposes. See *Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994*, *in* GATT, *supra* note 7, at 172-80.

52. Ronald Wellington Brown, Esq., *Economic and Trade Related Aspects of Transborder Data Flow: Elements of a Code for Transnational Commerce*, 6 NW. J. OF INTL. LAW & BUS. 1, 11 n.34 (Spr. 1984). The United States Customs Service has valued software exclusive of its information component since the 1960s. United States Department of Commerce International Trade Administration, *Preliminary Affirmative Countervailing Duty Determination: Certain Computer Aided Software Engineering Products from Singapore*, 55 FR 1596, 1598 (Jan. 17, 1990) [hereinafter U.S. Dept. of Commerce Preliminary Determination].

53. Brown, *supra* note 52, at 11 n.34, 14 n.44. It should be noted that although the European Community requested the Committee to adopt this compromise position, no EC member nation charges duties on the full transaction value of software. *See* U.S. DEPARTMENT OF COMMERCE OFFICE OF COMPUTERS & BUSINESS EQUIPMENT, TARIFFS AND OTHER TAXES ON COMPUTER HARDWARE AND SOFTWARE 3 (May 1994) [hereinafter U.S.

The United States proposal to tax software according to the cost of the carrier media alone, as ratified by the Committee in Decision 4.1,[54] has clearly become the prevailing international standard for software valuation.[55] Nearly every nation in the world that is a signatory to the GATT accord excludes software data content from dutiability.[56]

Widespread acceptance of the media-based valuation method is due to the recognition of a number of considerations. First, because of the digital nature of software, it can readily be transmitted across international borders by "invisible means," such as telephone lines, thereby avoiding customs altogether.[57] Software can also be imported on master disks and reproduced within the country of import, in which case only the master tape is subject to duty.[58] In light of these alternatives, it is arbitrary and unfair to single out software imported via tangible carrier media, such as diskettes, for imposition of substantially

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DEPT. OF COMMERCE TARIFF SCHEDULE] (showing that EC nations exempt software content from dutiability and charge a 0% duty rate on software carrier media).

54. *See supra* notes 52 & 53.

55. *See* U.S. DEPT. OF COMMERCE TARIFF SCHEDULE, *supra* note 53, at 3-15 (indicating that the vast majority of countries exclude software data content from dutiability); *IACC Special 301 Submission*, *supra* note 19, at 35 (media-only valuation is "used by the great majority of the world's nations"); *Wang & Wang Brief*, *supra* note 19, at 1 (same).

56. *See supra* note 55. Moreover, all Asian nations, except India (which charges an excessive 85% duty on software content) and China, charge duties on software media only. U.S. DEPT. OF COMMERCE TARIFF SCHEDULE, *supra* note 53, at 5-6. According to the Tariff Schedule, Korea values software strictly according to its carrier media, reflecting the U.S. government's belief that this was Korea's policy. *Id.* at 5.

57. *See* U.S. Dept. of Commerce Preliminary Determination, *supra* note 52, at 1598 (Congress identified telecommunications transmissions and similar "intangibles" as exempt from the provisions of the Harmonized Tariff Schedule); Borking, *supra* note 50, at 11 (observing that import duties cannot be fixed when software is transmitted by telephone lines or satellite channels). Korea does not levy tariffs on software imported electronically. Woo Hyun Baik & William C. Choi, *Korea: Computer Software Taxation*, Asia Pac. Tax Bull. 10, 16 (Jan. 1995).

58. *See* Yoong Neung Kee & Young-Cheol Jeong, *Software Licensing Fees: NTA Guideline on Withholding Tax; Licensors Need to Take Care in Structuring Their Marketing Arrangements*, 16 E. Asian Exec. Rep. (Int'l Exec. Rep., Ltd.) No. 3, at 7 (Mar. 15, 1994) (a software importer may reduce customs duties by importing a master copy of software and reproducing it locally). Most countries, including Korea, exempt royalties paid for the right to reproduce software in the country of importation from customs duties. *See* Art. 3-3, §1 of the Enforcement Decree of the Korean Customs Act (providing that royalties paid for the right to reproduce software within Korea are not dutiable); Valuation No. 22740-249 of the Central Customs Service (June 18, 1993) (same); Baik & Choi, *supra* note 57, at 16 (indicating that the license agreement should clearly specify the amount of royalties attributable to the reproduction right to qualify for the exemption). Baik and Choi point out that it makes little sense for Korea to exclude reproduction royalties but not sales royalties from customs duties, given that software is ordinarily reproduced for purposes of sale.

higher duty rates based on the value of its content.[59] This is especially true in light of the fact that carrier media such as diskettes are ordinarily a mere temporary means of storing information until it is transferred to an end-user's computer.

Second, the imposition of duties on software content is tantamount to the taxation of data, which is traditionally duty-free in order to promote the free flow of information across international borders.[60] As one U.S. official stated, the unimpeded global exchange of information is of great importance:

> Competition and the free flow of knowledge and ideas, regardless of their popularity, are cornerstones of the industrialized nations of the free world. . . . To some extent all civilization has been built upon the transfer of information from one person to another from one generation to the next. We must guard against the inclination to erect artificial barriers to information flows.[61]

Moreover, maintenance of this international "information superhighway" is of particular significance to American business interests:

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59. *See* Borking, *supra* note 50, at 11 (noting the position of the European Association of Manufacturers of Business Machines and Data Processing Equipment (EUROBIT) and the Federation Europeenne des Importateurs de Machine de Bureau (FEIM) that, insofar as software is "instructions" stored only temporarily on data carriers that can alternatively be transferred by telecommunication lines, orally, by post, or on magnetic tape, it should not be subject to import duties). According to Borking, the unfairness is magnified by the fact that smaller companies often cannot afford to transmit software by phone lines or satellite. *Id.* These companies are forced to pay import duties on the full transaction cost of software in Korea, while larger companies can import by alternative methods for free (although for other reasons, such as concern over the misappropriation of know-how, it may not be expedient to do so). *Id.* The smaller companies would probably shift the added costs to their customers, thereby distorting competition in the marketplace. *Id.* The equitable solution, Borking concludes, is to simply get rid of the import duties. *Id.*

60. For a detailed discussion of how Korean import taxes and U.S. export taxes affect the flow of technology from the U.S. to Korea, see Chang Hee Lee, *Taxation of U.S.-Korean Technology Transfer: A Developing Country's Point of View*, 10 Int'l Tax & Bus. Lawyer No. 1, at 1 (Summer 1992).

Perhaps the classic examples of "information" exempted from customs duties to promote the international exchange of know-how and ideas are books and computer manuals. These items are duty-free in the U.S. and Korea. *See* Tariff Schedules, Schedule 2, Part 5, 19 U.S.C. § 1202 (noting that books, newspapers, and periodicals are duty free in the U.S.); U.S. DEPT. OF COMMERCE TARIFF SCHEDULE, *supra* note 53 (listing a 0% duty rate for computer manuals in Korea). Charging duties on the information component of software is inconsistent with the practice of exempting books from dutiability, insofar as it discriminates between similar items based strictly on the format of the information contained therein (e.g., words on a piece of paper versus a machine-readable data sequence). Software is simply an advanced method of transmitting information from one source to another, and should be accorded the same consideration as its more traditional counterparts.

61. Brown, *supra* note 52, at 26 n.76 (quoting Mark S. Fowler, Chairman, Federal Communications Commission, before the OECD Committee for Information, Computer and Communications Policy, Paris, France (Dec. 13, 1982)).

> The United States has a special interest in maintaining the free flow of information. . . . Since the United States is currently the world leader in information technology and trade, international restrictions on the information industry most likely will affect United States business interests more than those of any other country. There could be a severe reduction in the currently massive amounts of United States revenue from the international information industry if burdensome regulations decrease the utility of information exchange systems.[62]

Encouraging the flow of information across national borders will also be beneficial for Korea, a nation still trying to build its technology base and industrial infrastructure. Sophisticated foreign software can aid in increasing the productivity and competitiveness of Korean companies and can facilitate the development of Korea's own software market.

Third, valuation of software data content may be a difficult and speculative endeavor.[63] Indeed, the U.S. Customs Service's decision to exclude software content from valuation was largely a result of the "considerable difficulty" it encountered in attempting to place a price on data.[64] Customs believed that by excluding the information component, it would create a more "fair, uniform, and neutral system for the valuation of goods consistent with the objective of the GATT Committee [on Customs Valuation]."[65] The United States was clearly not alone in this belief, as virtually every other Party to the GATT has now adopted the media-only valuation practice.[66]

It should be noted here that the exclusion of software data content from customs valuation is not inconsistent with the treatment of software stored on carrier media as a dutiable good.[67] On the contrary, while software data itself is a form of intangible intellectual property, once it is placed on a carrier medium such as a diskette, it

62. Jane A. Zimmerman, *Transborder Data Flow: Problems with the Council of Europe Convention, or Protecting States from Protectionism*, 4 N.W. J. INT'L. L. & BUS. 601, 604 (Autumn 1982). *See also* Mendoza, *supra* note 23, at 98 ("promoting technology exportation is profitable not only for U.S. companies, but for the U.S. economy as well."). The international information "highway" is certainly important to the business interests of other countries as well. For instance, a recent Associated Press release indicated that western European leaders' failure to embrace the "Infobahn" had "cost them millions of jobs," and that other countries slow on the uptake "could, in less than a decade, face disastrous declines in investment and a squeeze on jobs." Associated Press, *Europe Stuck in Slow Lane: Few Roads Laid for Data Highway*, S.F. CHRON., Feb. 24, 1995, at B3.

63. *See* Borking, *supra* note 50, at 11-12 (one factor in favor of abolishing import duties on software is the inability of customs authorities to accurately value data content).

64. U.S. Dept. of Commerce Preliminary Determination, *supra* note 52, at 1598.

65. *Id.*

66. *See supra* note 55 and accompanying text.

67. *See* U.S. Dept. of Commerce Preliminary Determination, *supra* note 52, at 1597.

takes on the characteristics of tangible merchandise.[68] In a 1990 Preliminary Determination concerning the applicability of countervailing duty law to computer software imported from Singapore, the United States Department of Commerce likened software stored on carrier media to books, newspapers, and magazines, insofar as these items derive their value from their intangible components but are treated as merchandise for customs purposes.[69] The Department of Commerce also expressly stated that the U.S. Customs Service, in "imposing duties on the basis of the recording area of the carrier medium without regard to its software component . . . treats such imports as merchandise."[70] Accordingly, although the U.S. Customs Service exempts software data content from dutiability for the previously-stated reasons, it does tax the physical carrier media on which the data is contained.[71] The author believes that charging duties on carrier media is an acceptable practice and does not contest the Korean government's right to use this method of taxation. However, the author does dispute Korea's decision to change its valuation policy to charge duties on software data content, insofar as this decision aligns Korea with a small minority of nations that are out of step with prevailing international standards.[72]

B. Non-Transparency of Policy

Korea's change in its software valuation policy came largely without warning, since the Korean government failed to enact any laws or regulations implementing the new valuation practice, or to otherwise alert affected businesses of its existence.[73] Many foreign importers

68. *Id.* The Department stated, "a tangible object which embodies intellectual property is merchandise." *Id.*

69. *Id.* at 1598.

70. *Id.* at 1597. The Department of Commerce listed six characteristics of software which render it "merchandise" for customs purposes:

> it is (1) A pre-packaged copyrighted software product that can be purchased off-the-shelf, (2) Typically contained on a carrier medium, (3) A pre-written product with broad application, which does not need additional servicing by the seller of the software prior to use by the end-user, (4) Marketed similarly to other types of merchandise, (5) Maintained in inventory by vendors, and (6) Treated differently than non-recorded carrier media by the U.S. Customs Service.

Id. at 1599. The Department of Commerce found these characteristics applicable even though the software imported was not the final pre-packaged product, but rather master disks used to produce the final product. *Id.*

71. *Id.*

72. *See supra* note 55 and accompanying text.

73. *ITAA Special 301 Submission*, *supra* note 19, at 2; *Wang & Wang Brief*, *supra* note 19, at 6. *But cf.* Baik & Choi, *supra* note 57, at 16, stating that the Korean Customs Tax Law adopts transaction-based valuation for software. In fact, the Law merely restates the provisions of the Agreement on Implementation of Art. VII of GATT, which does not refer to software specifically and cannot be said to settle the question of its proper valua-

learned of the change only when they were subjected to an internal audit by Korean Customs and charged with substantial fines for "back duties."[74] One notable example of this is the case of Computer Associates International, Inc., an American company accused in 1994 by the Seoul Customs Office of failing to declare the proper transaction value of software it had been importing into Korea since 1989.[75] Customs officials raided the offices of the company's Korean subsidiary and subjected its managers to lengthy interrogations and threats of extended imprisonment, based on charges that it had intentionally evaded over $1 million in customs duties by declaring only the media value of its imported software.[76] The company had operated in Korea for several years, openly following the media-only valuation method, believing that it was consistent with Korean practices.[77] Despite Com-

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tion. *See* Borking, *supra* note 50, at 14 ("The status of software on importation is not clear world-wide. The GATT Customs Value Code gives no assistance."). Given the uniqueness of software, most other developed nations have published separate rules or regulations setting forth their software valuation policies, whether they be transaction-based or based on media-only. The need for such transparency is particularly necessary where, as in Korea, transaction-based valuation has been sporadically applied in practice. Korean Customs has issued internal guidelines stating that software content as well as media is dutiable. Central Customs Service, *Notification of Matters to be Attended to When Taking in and Clearing Software Through Customs*, Evaluation 22740-94 (Jan. 13, 1989); *Wang & Wang Brief*, *supra* note 19, at 6. Such guidelines, however, are strictly for use by customs officials and are unknown to the general business community. *Wang & Wang Brief*, *supra* note 19, at 6. Moreover, such internal guidelines do not have the force of law in Korea. *Id.*

74. *IACC Special 301 Submission*, *supra* note 19, at 37; *ITAA Special 301 Submission*, *supra* note 19, at 3; *Wang & Wang Brief*, *supra* note 19, at 4. Foreign firms in other newly "liberalized" industries, such as cosmetics, have also faced customs valuation audits as part of a larger scheme to protect domestic businesses and discourage "luxury" imports. 1995 COUNTRY REPORTS, *supra* note 10, at 70.

75. Glain, *U.S. Trade Dispute Simmers with Korea*, *supra* note 4; *IACC Special 301 Submission*, *supra* note 19, at 34-35; *ITAA Special 301 Submission*, *supra* note 19, at 3; *Wang & Wang Brief*, *supra* note 19, at 1-2. Computer Associates is the second largest computer software company in the world. *Unofficial Transcript of Select Revenue Measures Hearing*, *supra* note 49.

A similar customs dispute arose in 1992 with Oracle Corp., the third largest computer software company in the world. *Wang & Wang Brief*, *supra* note 19, at 5 n.8; *ITAA Special 301 Submission*, *supra* note 19, at 3; *Unofficial Transcript of Select Revenue Measures Hearing*, *supra* note 49.

76. Glain, *U.S. Trade Dispute Simmers with Korea*, *supra* note 4; *IACC Special 301 Submission*, *supra* note 19, at 34-35; *ITAA Special 301 Submission*, *supra* note 19, at 3; *Wang & Wang Brief*, *supra* note 19, at 1-2.

77. Glain, *U.S. Trade Dispute Simmers with Korea*, *supra* note 4; *IACC Special 301 Submission*, *supra* note 19, at 34-35; *ITAA Special 301 Submission*, *supra* note 19, at 3; *Wang & Wang Brief*, *supra* note 19, at 1-2. Indeed, the U.S. government itself believed that Korea followed the media-only valuation method. *See* U.S. DEPT. OF COMMERCE TARIFF SCHEDULE, *supra* note 53, at 5 (indicating that Korea charges a 9% duty rate on software carrier media only). This belief was confirmed as recently as November 1994, in a letter written by Jonathan Menutti of the U.S. Foreign Commercial Service in Seoul. *Wang & Wang Brief*, *supra* note 19, at Exhibit 3.

puter Associates' apparent good faith and lack of notice of the transaction-based valuation policy, authorities commenced proceedings against its Korean-American manager for customs fraud (a crime carrying a possible ten-year prison term) and imposed a substantial bill for unpaid tariffs.[78]

The Korean government's failure to publish any rule, regulation, or law notifying foreign importers of its importation policies with respect to computer software may well be violative of the transparency requirements of Article X[79] of the GATT accord that provides:

> 1. Laws, regulations, judicial decisions and administrative rulings of general application, made effective by any contracting party, pertaining to the classification or the valuation of products for customs purposes, or to rates of duty, taxes or other charges . . . shall be published promptly in such a manner as to enable governments and traders to become acquainted with them. . . . 2. No measure of general application taken by any contracting party effecting an advance in a rate of duty or other charge on imports under an established and uniform practice, or imposing a new or more burdensome requirement, restriction or prohibition on imports . . . shall be enforced before such measure has been officially published. . . . 3(a). Each contracting party shall administer in a uniform, impartial and reasonable manner all its laws, regulations, decisions and rulings of the kind described in paragraph 1 of this Article.

Paragraph (1) of Article X requires that the customs regulations of a contracting party be sufficiently transparent so as to put foreign governments and companies on notice of all procedures, tariffs and penalties applicable to the importation of goods. Korea has not met this requirement with respect to the importation of software, because it has no published rules, regulations, or laws specifying that it charges a duty on software content in addition to media.[80] Moreover, because

78. *IACC Special 301 Submission*, *supra* note 19, at 34-35; *ITAA Special 301 Submission*, *supra* note 19, at 3; *Wang & Wang Brief*, *supra* note 19, at 1-2.

79. The text of Article X of the original GATT of 1947 was incorporated without change into the Final Act Embodying the Uruguay Round of Multilateral Trade Negotiations.

Korea's failure to publish its software valuation policy may also be violative of Article VII, Paragraph 5 of GATT, which states as follows:

> The bases and methods for determining the value of products subject to duties or other charges or restrictions based upon or regulated in any manner by value should be stable and should be given sufficient publicity to enable traders to estimate, with a reasonable degree of certainty, the value for customs purposes.

80. *See supra* note 73 and accompanying text. Lack of transparency is a common problem with Korean Customs' procedures, because there is a paucity of published rules or regulations concerning the importation of goods. Glain, *South Korea's Cutting Edge is Dulled*, *supra* note 14 ("Key regulations are often unpublished and selectively enforced."). In fact, even Korea's own trade officials recognize their import laws could be more clearly stated: "When we announce a plan, it isn't detailed . . . Our government doesn't under-

Korea's prior practice was to solely levy duties on software media,[81] the government should have been required to officially publish any change in its valuation of software constituting a "new or more burdensome requirement . . . on imports," before such a change could be enforced under paragraph (2) of Article X. Even Korea's domestic laws imply that no government regulations will become effective until they are published.[82] For instance, Article 53 of the Korean Constitution and Article 13 of the Act Concerning Publication of Laws and Regulations generally provide that Presidential decrees and agency regulations become effective 20 days after promulgation (i.e., official publication) to the public.[83] Lastly, even if the Korean Customs Act could be interpreted as authorizing the imposition of duties on software content,[84] Korea's inconsistent application of such a policy, coupled with the confusion to importers posed by the unique nature of software, may necessitate the publication of separate software valuation rules under the reasonableness provision of paragraph (3) of Article X.

C. Effect of Transaction-Based Valuation on Software Importers

The economic effect of Korea's transaction-based valuation policy on foreign software importers is substantial, because there is a significant difference in cost between software media and the total transaction value of software (media plus content).[85] For companies

stand clearly what the new [policies] should be." Glain, *U.S. Trade Dispute Simmers with Korea*, *supra* note 4 (quoting an official from the Korean Ministry of Foreign Affairs). Lack of transparency permits Korea's bureaucrats a great deal of discretion to disfavor an importer depending upon whether they want to promote a foreign or a domestic company. Telephone Interview with Christina Lund, Office of the United States Trade Representative (Jan. 4, 1995).

81. *See supra* note 73 and accompanying text. Korean Customs disputes this assertion. Clearly, if Korea has always maintained a transaction-based valuation policy, it was known to few, as it was not set forth in any published law, rule, or regulation and it was only sporadically and arbitrarily applied. *Id.* Moreover, standard international practice prior to the effective date of the GATT Customs Valuation Code was to value only the media component of software, in accordance with the 1950 Brussels Definition of Value. Korea presumably followed this practice as a signatory of the Brussels Agreement. If it subsequently altered its policy upon the enactment of the GATT Valuation Code, it did not do so publicly.

82. *IACC Special 301 Submission*, *supra* note 19, at 38; *Wang & Wang Brief*, *supra* note 19, at 7.

83. *IACC Special 301 Submission*, *supra* note 19, at 38; *Wang & Wang Brief*, *supra* note 19, at 7.

84. *See supra* note 73 and accompanying text.

85. *See* Borking, *supra* note 50, at 13 (observing that transaction-based valuation will result in a "substantial increase" in customs duties imposed on imported software, "a development [which] was neither foreseen nor intended and clashes with the basis of the GATT.").

importing a large volume of software into Korea, this difference may amount to tens of thousands of dollars in customs duties per year. A natural corollary of this increase in cost to importers is the inflation of the market prices of foreign software programs to Korean customers,[86] making such programs less competitive than more reasonably priced domestic products.

Another detrimental effect of this new valuation policy is that it is likely to increase incentives for end-user software piracy, because price inflation will encourage end-users to illegally copy, rather than purchase, imported software programs.[87] End-user piracy is already a major problem in Korea. Indeed, the country has been on the United States Trade Representative's Priority Watch List since 1992 due to its failure to adequately enforce foreign intellectual property rights.[88] In 1994 alone, end-user software piracy resulted in losses to the U.S. computer software industry of approximately U.S. $313 million, more than seven times the losses suffered by the motion picture, book, and music industries combined.[89] Korea's poor record on intellectual property rights ("IPR") protection in the software industry appears inconsistent with its current campaign of cracking down on software importers for alleged violations of its transaction-based valuation policy, particularly Computer Associates, whose Korean-American director was criminally indicted for evasion of customs duties.[90] Criminal

86. *IIPA Submission, supra* note 50, at 51. The increased price also raises the overall production costs of the Korean end-user.

87. *Id.* at 51-52.

88. *Id.* at 49. *See also* Office of the United States Trade Representative, *USTR Announcement and Fact Sheets on Decisions Affecting Foreign Government Procurement, Intellectual Property Protection, and U.S.-Japan Supercomputer Pact*, 11 Int'l Trade Rep. (BNA) 722, 725 (May 4, 1994) (while Korea has made improvements in intellectual property protection, it has remained on the USTR's "Priority Watch List" due to lingering concerns over its "inadequate intellectual property laws" and insufficient resources for enforcement and prosecution of piracy "especially for software").

89. *IIPA Submission, supra* note 50, at 49. The book, motion picture, and music industries reported an additional $43 million loss due to piracy in Korea. *Id.*

Improvements in intellectual property rights protection have been slow to occur in the software industry because Korean officials are often reluctant to conduct raids on large domestic companies that are the most serious infringers. Telephone Interview with Jim Zumwalt, *supra* note 23. *See also* James M. West, *Legal Recourse against Software Piracy in South Korea: Progress, Problems and Prospects* 7 (Nov. 1993) (attached as Exhibit 9 to *IACC Special 301 Submission*) (as of 1993, criminal prosecutions for software piracy against large end-users were "few and far between," and those prosecutions that were initiated were thought to be "public relations exercise[s] to deflect trade sanctions"); 1995 COUNTRY REPORTS, *supra* note 10, at 73 (indicating that while software piracy in Korea is widespread, authorities have conducted few raids of large end-users). Indeed, according to the IIPA, the Korean government's current attitude toward software piracy "can best be described as passive cooperation." *IIPA Submission, supra* note 50, at 50.

90. *IACC Special 301 Submission, supra* note 19, at 34, 39; *Wang & Wang Brief, supra* note 19, at 8.

indictments against major domestic IPR infringers in Korea are rare, and the burden of proof required for conviction is onerous.[91]

Lastly, the apparent willingness of Korean Customs authorities to impose retroactive civil and criminal penalties on importers for failing to comply with its non-transparent requirements, as demonstrated in the Computer Associates' incident, may have an *in terrorem* effect on other importers who in the past paid duties only on the value of software media.[92] These other companies may decide that it is wiser to settle with customs than risk criminal indictment of their employees and the uncertainty of a court battle that may be disruptive to business and create future tensions with government officials. Companies will undoubtedly pass the costs of any such settlement on to Korean customers, again making imported programs less competitive, and increasing incentives for end-user piracy.

In sum, the economic effects of Korea's transaction-based valuation policy, its exacerbation of the software piracy problem, and the *in terrorem* effect of retroactive actions against importers, when taken in combination, pose a substantial barrier to market access for American-made computer software.

II. Withholding Taxes on Software Revenue

In addition to charging customs duties on the full transaction value of imported computer software, the Korean government takes a second bite at the apple by levying withholding taxes on income generated from domestic sales of the same merchandise.[93] This double

91. *See supra* note 89 and accompanying text; *IACC Special 301 Submission*, *supra* note 19, at 39; *Wang & Wang Brief*, *supra* note 19, at 8; West, *supra* note 89, at 7, 10. According to Dr. West, as of late 1993, Korean prosecutors' attitude toward major end-user infringers was "conspicuously passive . . . [they] declin[ed] to open investigations or to conduct criminal raids unless the probable cause evidence submitted by the complainant [was] virtually conclusive." West, *supra* note 89, at 10.

92. *See* Software Publishers Association, 1995 "SPECIAL 301" REVIEW: Policies And Practices of Foreign Countries Regarding Intellectual Property Rights, at Appendix 2, p.7 (submitted to the Office of the United States Trade Representative) ("the prospect of criminal charges and imprisonment creates a climate of fear and uncertainty that discourages the importation of furnished packages of U.S. software [into Korea].").

93. WALTER H. DIAMOND, FOREIGN TAX AND TRADE BRIEFS: INTERNATIONAL WITHHOLDING TAX TREATY GUIDE, at Far East-24 87 et seq. (Matthew Bender 1990). Royalties derived from the sale or licensing of software are subject to a 15% withholding tax plus a 1.125% resident surtax in Korea, under the terms of the U.S.-Korea Tax Treaty. *See id.*; Kee & Jeong, *supra* note 58, at 7; Fred M. Greguras & Moon Sung Lee, *Computer Software License Agreements*, 14 E. Asian Exec. Rep. (E. Asian Exec. Rep., Inc.) No. 6, at 20 (June 15, 1992). This is to be distinguished from the 10% rate applicable to royalties on copyrighted works, which does not apply to software. Greguras & Lee, *supra*; DIAMOND, *supra*, at Far East-25 n.22. Software is also subject to a 10% value-added tax (VAT) in Korea. Greguras & Lee, *supra*.

taxation imposes a heavy additional cost burden on foreign software companies.[94]

The question whether it is appropriate to charge withholding taxes on income generated by the "sale" or "license" of computer software is currently the subject of some controversy in a number of countries, including the United States.[95] Because the United States is a leader in the high technology and information industries[96], its decision on this issue will undoubtedly have a great influence on the actions of many foreign taxing authorities. Moreover, the author believes that concerns of equity and fairness dictate that the United States should formally rule on the withholding tax question before it can reasonably request the Korean government to change its own policies. Accordingly, this Note argues that for purposes of both the U.S. Internal Revenue Service ("IRS") and the Korean National Tax Administration ("K-NTA"), it is inappropriate to charge withholding taxes on the revenue generated from the transfer of most computer software products. This Note will first address this issue from the perspective of U.S. tax principles to provide a basis for applying this argument to Korean law.

A. Analysis of U.S. Tax Principles

(1) Characterization of Software Revenue

At the heart of the withholding tax controversy is whether revenue derived from certain software transactions should be characterized as business profits from the sale of merchandise, or royalties from the licensing of intangible copyrighted works.[97] Under sections

94. When the withholding and value-added taxes are combined with the current 8% customs duty payable on the transaction value of software, the importer is faced with a total tax burden of over 34%. Greguras & Lee, *supra* note 93.

95. *See* Gary D. Sprague, *Current International Tax Problems in the Software Industry* 1-3 (Baker & Mackenzie, Palo Alto, CA) [hereinafter Sprague, *Current International Tax Problems*] (on file with THE HASTINGS LAW JOURNAL) (indicating that the National Office of the Internal Revenue Service has yet to formally adopt a position on this issue); Richard L. DeLap, *Pre-Packaged Software: Royalties or Sales of Goods?*, 21 INT'L TAX J. No. 3, at 1, 2 (Summer 1995) (same).

96. Zimmerman, *supra* note 62, at 604 (citing *International Data Flow: Hearings before the Subcomm. on Gov't Information and Individual Rights of the House Comm. on Gov't Operations*, 96th Cong., 2d Sess. § 36 (1980)).

97. For a thorough analysis of this question, see John M. Peterson, Jr., *Firm Proposes Ruling on Tax Treatment of Income from Software Transactions*, 91 TAX NOTES TODAY, Nov. 20, 1991, *available in* LEXIS, Legis Library, TNT File [hereinafter Peterson, *Firm Proposes Ruling*] (reprinting a letter to the Dept. of the Treasury from the law firm of Baker & Mackenzie, proposing issuance of a revenue ruling on the characterization of software revenue for federal income tax purposes). *See also* Baik & Choi, *supra* note 57, at 10 (briefly discussing characterization in connection with an analysis of Korea's tax policies); Committee on Fiscal Affairs, Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, *Commentary on Article 12*

881(a)(1) and 1442(a) of the Internal Revenue Code, a 30 percent tax is withheld from certain U.S. source "fixed or determinable annual or periodical income, paid to foreign corporations, to the extent such income is not effectively connected with the conduct of a trade or business within the United States."[98] Income derived from software transactions that can be characterized as "licensing" qualifies as royalties that are taxable "fixed or determinable annual or periodical income" under these provisions.[99] Conversely, income from software transactions that is characterized as "sales" of copyrighted merchandise qualifies as business profits that are not taxable under sections

Concerning the Taxation of Royalties, ¶ 12, C(12)-4 (Updated Sept. 1, 1992) [hereinafter *OECD Model Tax Convention Commentary*] ("[w]hether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders.").

Peterson cogently argues that revenue from most end-user software transactions should be characterized as business profits from the sale of goods, which are not subject to withholding tax. Peterson, *supra*. However, this proposal has met with fierce opposition from some software companies, most notably IBM, which claims that license characterization is essential to the enforcement of intellectual property rights under copyright law and its contractual user agreements. Ronald A. Pearlman & Deanna J. Hamilton, *IBM Opposes Ruling on Computer Software*, 92 TAX NOTES TODAY, Aug. 13, 1992, *available in* LEXIS, Legis Library, TNT File [hereinafter Pearlman & Hamilton, *IBM Opposes Ruling on Computer Software*]. IBM also asserts that a general ruling on characterization would be inappropriate given the great variety of license arrangements and terms that may be used in software transactions. *Id.* Peterson addressed these concerns in a second letter to the Department of the Treasury, see John M. Peterson, Jr., *Software Companies Battle IBM Over Characterization of Software Revenue*, 92 TAX NOTES TODAY, Oct. 1, 1992, *available in* LEXIS, Legis Library, TNT File [hereinafter Peterson, *Software Companies Battle IBM*] (arguing that tax characterization should have no bearing on the enforcement of the legal rights and obligations of the parties and that a "common set of facts" inherent in software transactions makes the issuance of a general revenue ruling feasible). This was followed by a counterattack from IBM. *See* Ronald A. Pearlman & Deanna J. Hamilton, *IBM Opposes Sale Treatment of Software Licensing Transactions*, 92 TAX NOTES TODAY, Dec. 24, 1992, *available in* LEXIS, Legis Library, TNT File [hereinafter Pearlman & Hamilton, *IBM Opposes Sale Treatment*] (stressing the factual variations among license transactions and the purported inadequacy of Baker & Mackenzie's proposed revenue ruling). Though the dispute between IBM and the software companies represented by Baker & Mackenzie was apparently resolved by an amendment to the U.S.-Canada Tax Treaty (which the latter companies had lobbied for), the characterization question has yet to be formally answered by the IRS or the Treasury Department. Baik & Choi, *supra* note 57, at 14 n.17.

98. Peterson, *Firm Proposes Ruling*, *supra* note 97; I.R.C. §§ 881(a)(1), 1442(a); 1 JOEL D. KUNTZ & ROBERT J. PERONI, U.S INTERNATIONAL TAXATION A1-60, A1-67 (1992); John J. Cross III, *Taxation of Intellectual Property in International Transactions*, 8 VA. TAX REV. 553, 563, 574 (Winter 1989).

99. Cross, *supra* note 98, at 574 (*citing* 26 C.F.R. § 1.1441-2(a)(1)); Peterson, *Firm Proposes Ruling*, *supra* note 97. I.R.C. § 861(a)(4) further provides that royalties paid for the right to use a copyright in the U.S. qualifies as U.S. source income. Peterson, *Firm Proposes Ruling*, *supra* note 97.

881(a)(1) and 1442(a).[100] Whether a transaction is characterized as a "license"[101] or a "sale" should depend upon the rights actually conferred to the end-user in a transfer of the product, rather than upon the fact that the transfer is made pursuant to a license agreement.[102] Indeed, under U.S. tax principles, "[i]t is well established that whether a transaction is a sale or a license for tax purposes depends on the substance of the transaction, not on the form or the label accorded the transaction by the parties."[103]

Applying this substance-over-form analysis, the transfer of certain pre-packaged, "off the shelf" software products to an end-user for a fixed, lump-sum price should qualify as a sale of goods not subject to the withholding tax provisions of the Internal Revenue Code.[104] According to Rev. Rul. 55-540[105], a transaction may be characterized as a sale

> "If the sum of the specified 'rentals' over a relatively short part of the expected useful life of the equipment approximates the price at which the equipment could have been acquired by purchase at the

100. Cross, *supra* note 98, at 563 (citing 26 C.F.R. § 1.1441-2(a)(3)); Peterson, *Firm Proposes Ruling*, *supra* note 97.

101. A license may be defined as a transfer of "less than substantially all of the bundle of rights representing an item of intellectual property for the legal life of the intellectual property." Cross, *supra* note 98, at 572. With respect to computer software, a license is created by a transfer of less than substantially all of the copyright owner's interest in the software copyright. Peterson, *Firm Proposes Ruling*, *supra* note 97.

102. Peterson, *Firm Proposes Ruling*, *supra* note 97. Almost all software transfers are subject to some form of license agreement, the purpose of which is to either (a) document the rights granted to the distributor/reseller (e.g., in a reproduction license) and/or (b) set forth terms protecting the intellectual property rights of the copyright owner (e.g., in the standard end-user transaction). *Id.* When a license agreement supplements the copyright law, and does not transfer any rights in the copyright itself, thereby failing *in substance* to create a license, it is important to apply the substance-over-form principle to determine proper revenue characterization. *Id.* (emphasis added); *see also* DeLap, *supra* note 95, at 1 (noting that sales of pre-packaged software may improperly be subject to withholding tax "[b]ased solely on the *form* of the transaction (i.e., the existence of a 'license agreement')") (emphasis added). *Cf.* Pearlman & Hamilton, *IBM Opposes Sale Treatment*, *supra* note 97 ("a determination of tax ownership is 'a question of fact which must be ascertained by the written agreements, which are read in light of the attending facts and circumstances.'") (quoting TAM 9237045 (May 6, 1992)).

103. Peterson, *Firm Proposes Ruling*, *supra* note 97 (citing Frank Lyon Co. v. U.S., 435 U.S. 561, 573-74 (1978), Waterman v. Mackenzie, 138 U.S. 252, 256 (1891)); *see also* Sprague, *supra* note 95, at 2 ("Under U.S. tax principles . . . the economic substance of a transaction should prevail to determine the character of revenue rather than the legal form involved."); Rev. Rul. 55-540, *infra* note 105, at 41 §4. *Cf.* Pearlman & Hamilton, *IBM Opposes Ruling on Computer Software*, *supra* note 97 (listing the ownership attributes set forth by the Court in *Lyon* that are relevant to a determination of whether a transaction is a lease or a sale).

104. Sprague, *supra* note 95, at 2; Peterson, *Firm Proposes Ruling*, *supra* note 97.

105. Rev. Rul. 55-540, C.B. 1955-2, 39. Revenue Ruling 55-540 discusses lease versus sales characterization with respect to equipment used in a trade or business. *Id.*

> time of entering into the agreement . . . and the lessee may continue to use the equipment for an additional period or periods approximating its remaining estimated useful life for relatively nominal or token payments.[106]

In certain basic software transactions, an end-user will purchase a pre-packaged software product from a retailer or distributor for a one-time, fixed fee.[107] The software typically contains a form license agreement, to which the purchaser assents by opening the package or loading the program onto a computer.[108] Although these licensing agreements may differ from one manufacturer to the next,[109] they generally provide that a purchaser has the right to use the software in his/her home or business for the duration of its useful life. The purchaser, however, is not entitled to copy the software (except possibly for archival purposes, or if otherwise necessary to make the program perform its stated function), decompile, sublicense, rent, lease or reverse engineer it, or use it on more than one computer.[110] Thus, for purposes of Rev. Rul. 55-540, the end-user obtains the right to use a software program for the duration of its useful life, and pays a price up-front that is commensurate with the value of that right.[111] The fact that the use is restricted to a limited degree by the terms of the license agreement does not alter the tax characterization of the transaction as a sale, because no transfer of rights in the underlying copyright occurs that would *in substance* create a license.[112]

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106. *Cf.* Pearlman & Hamilton, *IBM Opposes Sale Treatment*, *supra* note 97 ("the relevant indicia of tax ownership may include factors beyond those relied upon by the Rev. Rul. 55-540 analysis").

107. Peterson, *Firm Proposes Ruling*, *supra* note 97.

108. Pearlman & Hamilton, *IBM Opposes Ruling on Computer Software*, *supra* note 97.

109. *Id.*

110. Peterson, *Software Companies Battle IBM*, *supra* note 97. This description is somewhat oversimplified, but should be adequate for purposes of tax analysis. *Id.*

111. *Id.*; *see also* Peterson, *Firm Proposes Ruling*, *supra* note 97.

112. *See* DeLap, *supra* note 95, at 1 (although pre-packaged software is usually sold pursuant to a standard license agreement, the agreement does not confer on the buyer any right to sub-license the product. Accordingly, "[f]rom an economic point of view . . . this license essentially represents a sale of goods."); Peterson, *Software Companies Battle IBM*, *supra* note 97 (arguing that software transactions are more akin to sales than licenses where "[e]nd-users pay for the use of the copyrighted article for its useful life, not for a license to exploit the copyright by copying the program for resale or for transfer to non-paying users."). This type of transfer is analogous to transactions involving other copyrighted articles, such as books, where the purchaser pays a set fee for the right to perpetually use the article, but does not obtain the right to reproduce or otherwise commercially exploit the underlying copyright. Peterson, *Firm Proposes Ruling*, *supra* note 97. Insofar as transfers of items like books are treated as sales for federal income tax purposes, so too should transfers of pre-packaged "off the shelf" software. *Id.*

Applicability of sale treatment under Rev. Rul. 55-540 should extend to more complex software transactions as well.[113] Indeed, in an industry ever striving to increase efficiency and lower costs, many alternative arrangements have been developed to distribute software to large, high volume end-users, such as corporations and government agencies.[114]

One alternative is site licensing, whereby the customer pays an upfront fee for one copy of a program and the limited right to make additional copies for internal on-site use only.[115] Where a customer has hundreds of on-site users, site licensing permits the software seller to provide programs in a manner more efficient than delivery of individual program copies to each user.[116] As with more simplified software transactions, however, the customer still pays a fixed fee for the right to use the software for the duration of its useful life.[117] Moreover, although the customer does obtain a limited right to reproduce the software, copies that are only for on-site use may not be sold or transferred to third parties.[118] Thus, the right to control and exploit the underlying copyright remains with the copyright owner.[119] This fact is reflected in the purchase price of the software, which is substantially less than it would be if the customer purchased the right to exploit the copyright.[120] Indeed, site licensing often costs less than

113. *See id.* For a detailed argument that sale characterization should not apply to more complex software transactions, such as bulk license transactions, see Pearlman & Hamilton, *IBM Opposes Sale Treatment*, *supra* note 97 (arguing that factors such as the bulk licensee's acquisition of the right to reproduce program copies and its waiver of the right to alienate such copies weigh in favor of license characterization). Pearlman and Hamilton also argue that IBM's willingness under certain circumstances to allow a customer to copy its pre-packaged programs at no extra charge (e.g., when the customer's copies were destroyed by fire, or when necessary to facilitate the customer's transition to a new program) demonstrates that it "is not in the business of selling physical program copies. . . . [but is] in the business of granting customers a right to use licensed computer programs." *Id.* Of course, one might also surmise that the customers in question are large corporate or government entities, and that IBM's generosity has more to do with good business practices (i.e., promoting goodwill and keeping the customer from switching to another software provider) than with licensing per se.

114. Peterson, *Firm Proposes Ruling*, *supra* note 97.

115. *Id.* Copies may be reproduced onto multiple computer disks, or, more commonly, by electronic transmission to the users' computers. *Id.*

116. *Id.; see also* Sprague, *supra* note 95, at 2 ("from the perspective of the software supplier, a site license is merely an alternative method of delivering its product, which also could be accomplished by delivering numerous copies of the product package.").

117. Peterson, *Firm Proposes Ruling*, *supra* note 97. Conceptual difficulties may arise when new on-site users are added, requiring the payment of additional fees. *Id.* However, this transaction, in substance, is no different than one in which new users are physically provided with their own separate program copies for a fixed, up-front fee. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

the price the customer would have paid had the seller delivered individual program copies to each on-site user.[121]

Another arrangement commonly made for large-scale end-users to promote efficiency and lower costs is the sale of a single program copy to a customer for use on a local area network ("LAN").[122] In this type of transaction, the customer typically pays an upfront fee that covers the cost of a single copy plus the number of additional users who will access the program.[123] Selling a single program copy for network use is more efficient and makes more sense than selling multiple copies for each user in the customer's business (indeed, the latter approach would partially defeat the purpose of networking altogether). As with site licensing, the end-user still pays a fixed fee for the perpetual use of the product with no accompanying right to commercially exploit the underlying copyright.[124] Thus, while LAN end-user transactions differ from more basic software sales, this difference is one of form, not substance.

Pre-packaged end-user transactions, network transactions, and site licensing should be distinguished from arrangements in which a purchaser obtains the right to exploit the underlying software copyright for resale purposes. In the latter transaction, a sale does not occur unless the copyright owner sells "all substantial rights," including the rights to exclusively and perpetually use, copy, and sell the software, to the purchaser.[125] Where a copyright owner transfers less than the complete interest in his or her copyright, the transaction is considered a license subject to the withholding tax provisions of the Internal Revenue Code.[126] One example of such a transaction occurs when a foreign software company licenses to a domestic company the non-exclusive right to reproduce its software from master disks for

121. *Id.* The reduced price may reflect a volume discount coupled with the cost-savings of delivering the software by way of the site license arrangement. *Id.*

122. *Id.*

123. *Id.*; *see also* Pearlman & Hamilton, *IBM Opposes Sale Treatment*, *supra* note 97 ("The customer pays IBM a base charge for the right to use the LAN Server program PLUS an additional license fee for each existing workstation in the customer's computer network.").

124. Peterson, *Firm Proposes Ruling*, *supra* note 97. *But cf.* Pearlman & Hamilton, *IBM Opposes Sale Treatment*, *supra* note 97 (stating that "[s]uch a usage-based fee, even if paid as a one-time charge, is a classic illustration of a license arrangement.").

125. Peterson, *Firm Proposes Ruling*, *supra* note 97; Rev. Rul. 75-202, C.B. 1975-1 170; Rev. Rul. 60-226, C.B. 1960-1 26. Moreover, even if all substantial rights are transferred, if payment from buyer to seller is contingent upon the buyer's use of the copyright, the transaction will still be subject to withholding tax under I.R.C. § 881(a)(4). Peterson, *Firm Proposes Ruling*, *supra* note 97. Section 881(a)(4) provides that "gains from the sale of a copyright or any interest in a copyright are subject to withholding to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the copyright." *Id.*

126. Peterson, *Firm Proposes Ruling*, *supra* note 97.

packaging and resale to domestic end-users.[127] In return, the domestic company pays the foreign company a percentage of income from the resale of the software, rather than a fixed fee up-front.[128] The transfer of the right to reproduce the software for resale from the foreign company to the domestic company is a transaction in the copyright itself.[129] Moreover, because the right to reproduce is non-exclusive, there has not been a transfer of "all substantial rights," and the arrangement would be characterized as a license.[130] The key distinction between the license arrangement and the aforementioned end-user, network, and site licensing transactions is that the former involves the transfer of an interest in a copyright, whereas the latter involves the transfer of a copyrighted article.[131]

In sum, under United States tax principles, revenue derived from pre-packaged, network, and site-license transactions, where there is no accompanying right to reproduce the software for resale or to otherwise commercially exploit the underlying copyright, should be characterized as business profits from the sale of goods and not subject to federal withholding tax. It is true that software itself consists of copyrightable intellectual property,[132] but it is nonetheless transformed into a copyrighted article when it is stored on carrier media and sold in the stream of commerce.[133] This merchandise characterization should not change when software is purchased in a site license or LAN network transaction, insofar as the limited right to reproduce granted to the purchaser is solely for purposes of efficiency and cost-effectiveness, and there is no transfer of an interest in the copyright itself.[134]

127. *Id.*; *see also OECD Model Tax Convention Commentary*, *supra* note 97, Par. 13, at C(12)-5 (an author's transfer of part of his rights in software to a third party for purposes of commercial exploitation gives rise to license characterization).

128. Peterson, *Firm Proposes Ruling*, *supra* note 97.

129. *Id.*

130. *Id.*

131. *Id; see also* Peterson, *Software Companies Battle IBM*, *supra* note 97 (discussing the difference between the underlying copyright and the copyrighted article). The IRS apparently adopted the "copyright" versus "copyrighted article" distinction in TAM 9231002 (Aug. 3, 1992), determining that a taxpayer's extended maintenance contracts for software involved a "sale or other disposition within the meaning of 26 C.F.R. § 1.451-5(a)." *Id.*; *but cf.* Pearlman & Hamilton, *IBM Opposes Sale Treatment*, *supra* note 97 (arguing that the Service's analysis in TAM 9231002 was flawed). The distinction has also been made in the foreign sales corporation context. Peterson, *Firm Proposes Ruling*, *supra* note 97.

132. *See OECD Model Tax Convention Commentary*, *supra* note 97, at C(12)-5 ("The rights in computer software are a form of intellectual property.").

133. *See supra* notes 68-70 and accompanying text; Pearlman & Hamilton, *IBM Opposes Sale Treatment*, *supra* note 97 ("We do not dispute that a physical computer program copy is a copyrighted article.").

134. Peterson, *Firm Proposes Ruling*, *supra* note 97.

(2) OECD Model Tax Convention[135]

The argument that revenue from most pre-packaged, network, and site-license transactions should be characterized as business profits from the sale of goods is consistent with the approach taken by the Fiscal Affairs Committee of the Organization for Economic Cooperation and Development ("OECD") in its Model Tax Convention on Income and on Capital, revised as of September, 1992.[136] According to the OECD Commentary on Article 12 of the Convention:

> Transfers of rights [in software] occur in many different ways ranging from the alienation of the entire rights to the sale of a product which is subject to restrictions on the use to which it is put. . . . [where] the acquisition of the software [is] . . . for the personal or business use of the purchaser. . . . [t]he payment will then fall to be dealt with as *commercial income* in accordance with Articles 7 or 14. It is of no relevance that the software is protected by copyright or that there may be restrictions on the use to which the purchaser can put it.[137]

These principles should apply regardless of whether a sale involves the transfer of pre-packaged software to a single end-user, the transfer of a master program copy for internal on-site reproduction, or use on a LAN network, since in each situation the software is purchased for personal or business use.[138] In fact, while the Convention acknowledges that "difficulties can arise" when there is a partial transfer of rights subject to geographical limits (e.g., a site license), the payment of a usage-based fee (e.g., for a LAN server), or a substantial lump-sum payment, it states that such transactions generally give rise to commercial income or capital gains, not royalties.[139] The Convention also provides that where the copyright owner transfers part of his interest in the copyright itself to a third party for purposes of commercial exploitation, the transaction is a license and the income derived

135. The OECD was established in 1961 for the purpose of encouraging international "economic progress" and trade, and is comprised of 24 developed nations, including the U.S., Japan, Canada, and several European countries. McGee & Yoon, *supra* note 2, at 4 n.39. Although the Model Tax Convention is not binding on OECD members, it establishes a standard for taxation that is influential in shaping domestic policy. DeLap, *supra* note 95, at 2.

136. Sprague, *supra* note 95, at 2, 3; DeLap, *supra* note 95, at 2; Kee & Jeong, *supra* note 58.

137. *OECD Model Tax Convention Commentary*, *supra* note 97, at ¶¶ 12 & 14, C(12)-5 (emphasis added).

138. Peterson, *Software Companies Battle IBM*, *supra* note 97; Sprague, *supra* note 95, at 2, 3; Kee & Jeong, *supra* note 58.

139. *OECD Model Tax Convention Commentary*, *supra* note 97, ¶¶ 15 & 16, at C(12)-6.

therefrom is a royalty.[140] Income from the transfer of a *complete* interest in the copyright, however, is not a royalty.[141]

B. The Korean Approach

Although Korea is not yet a member of the OECD, it hopes to join the organization in 1996 and has officially stated that it will follow the OECD guidelines for international taxation.[142] However, Korea's policies and practices relating to the imposition of withholding taxes on software revenue draw this statement into question, because Korea has habitually rejected the application of nontaxable sale characterization to most computer software transactions.[143]

(1) 1993 Guidelines and 1994 Supplemental Guidelines

According to Guidelines issued by the K-NTA in September of 1993, virtually all types of software transfers involved the payment of royalties subject to withholding tax.[144] Not surprisingly, payments made in consideration for the right to reproduce and/or distribute software were deemed taxable royalties,[145] consistent with the idea that such transactions were in the copyright itself, rather than in the copyrighted article. The Guidelines, however, went further to indicate that certain transactions in the copyrighted article (termed transactions "to acquire know-how inherent in the software"[146]) were also taxable. Such transactions were subject to withholding tax when, for instance, payment was determined by the geographic limits of the transaction or the frequency of use or volume of products produced; the importer was required to keep the software confidential and was

140. *Id.* at ¶ 13, at C(12)-5; Sprague, *supra* note 95, at 3; Peterson, *Software Companies Battle IBM*, *supra* note 97; Kee & Jeong, *supra* note 58.

141. *OECD Model Tax Convention Commentary*, *supra* note 97, at ¶ 15, C(12)-6.

142. J.Y. Lee & R.M. Donaldson, *South Korea Moves to Ease Tax Rules Governing Foreign Companies*, 9 TAX NOTES INT'L 1711, 1711 (Dec. 5, 1994); John Turro, *Tax Treaties: U.S. and Korea Sign Memorandum of Understanding on Treaty Interpretation*, 8 TAX NOTES INT'L 562, 562-563 (Feb. 28, 1994); Gary D. Sprague, *Letter to the Editor: Korea Expected to Reverse Position on Withholding Tax on Software Products*, 8 TAX NOTES INT'L 453, 453 (Feb. 14, 1994).

143. *See* Gary D. Sprague, *Korea: New Tax Guidelines for Packaged Software*, 5 Software Taxation Letter 10, 10 (March 1994) [hereinafter Sprague, *New Tax Guidelines*] (Korea's 1994 internal Guidelines "impose . . . withholding tax on virtually all forms of packaged software product revenue paid to non-residents."); Baik & Choi, *supra* note 57, at 11, 15 (observing that withholding taxes were imposed on most software transfers under the 1993 Guidelines and that the current Guidelines appear to tax virtually all software other than "canned" programs).

144. Sprague, *New Tax Guidelines*, *supra* note 143, at 10; Baik & Choi, *supra* note 57, at 11.

145. Sprague, *New Tax Guidelines*, *supra* note 143, at 10; Baik & Choi, *supra* note 57, at 11.

146. Baik & Choi, *supra* note 57, at 11.

not able to alienate the program to a third party without permission; or the software was customized or sufficiently "high end" to be considered to contain know-how.[147] Although the 1993 Guidelines did expressly exempt transfers of standard pre-packaged software from taxation,[148] this exemption was substantially limited by a requirement that the software not exceed the technical level of programs that could be developed in Korea.[149] Tax officials in the field frequently took advantage of this limitation to levy taxes on most pre-packaged software payments.[150]

The K-NTA issued Supplemental Guidelines in June of 1994 to clarify the provisions of its earlier Guidelines as a result of political pressure from the U.S. and software industry complaints about Korea's aggressive tax policies.[151] These Supplemental Guidelines exempted pre-packaged, "off-the-shelf" software from Korean withholding tax, provided that it did not contain "know-how" as defined under Korean law, any applicable tax treaty, or Article 12 of the OECD Model Convention.[152] This position was consistent on its face with a Memorandum of Understanding ("MOU") signed by Korea and the U.S. in prior months, in which Korea pledged to follow OECD standards in interpreting the U.S.-Korea Tax Treaty and in treating software revenue as business profits not subject to withholding tax.[153] However, Korea subsequently denied that the MOU contained any such agreement on its part and Korean tax officials continued to exercise broad discretion in determining which software products generated taxable income.[154]

(2) 1994 Basic Rules

Korea eventually consolidated its two prior Guidelines on the issue of software taxation in its revisions to the Basic Rules of the Cor-

147. *Id.*; Sprague, *New Tax Guidelines*, *supra* note 143, at 10, 11.

148. The Guidelines also provided exemptions for bundled transactions (i.e., where software is sold pre-installed in hardware), as long as they were made in accord with "common trade practices." Sprague, *Current International Tax Problems*, *supra* note 95, at app. B, ¶ C(3); Sprague, *New Tax Guidelines*, *supra* note 143, at 11-12.

149. Baik & Choi, *supra* note 57, at 11; Sprague, *New Tax Guidelines*, *supra* note 143, at 11.

150. Sprague, *Current International Tax Problems*, *supra* note 95, at 12.

151. Baik & Choi, *supra* note 57, at 12; *see also* Lee & Donaldson, *supra* note 60, at 1711-12.

152. Baik & Choi, *supra* note 57, at 12. The Guidelines listed specific products that qualified for the tax break, so as to provide clear guidance to local tax officials. *Id.*

153. Turro, *supra* note 142, at 562; Sprague, *New Tax Guidelines*, *supra* note 143, at 12; Gary D. Sprague, *Korea: Treasury Department Issues Memorandum on Treaty*, 5 Software Taxation Letter 26, 26-27 (April 1994) [hereinafter Sprague, *Treasury Department*].

154. Sprague, *Treasury Department*, *supra* note 153, at 27.

porate Tax Law, which took effect in August, 1994 ("New Rules").[155] According to the New Rules, consideration paid for the right to exploit a software copyright (including reproduction and distribution) is still taxable as a royalty, as are payments made for software which contains "know how."[156] The presence of "know-how" is to be determined by the following criteria:

> 1. When a contractual obligation to preserve confidentiality other than prohibition under the Copyright Law for illegal reproduction, etc. is imposed.
>
> 2. When the price of the software is determined on the basis of the place, type of end users, frequency, productivity per period of use of the software, or the amount of products manufactured or information processed by such software.
>
> 3. When source code (language arrangement which constitutes the software program) of the software is provided.
>
> 4. When it is clear that the software contains technical information which is not disclosed to the public and which is essential for industrial reproduction of other products or production process.[157]

The New Rules exempted "shrink-wrapped" (i.e., pre-packaged) software imported "without a separate license agreement," including programs like DOS, Windows, Wordperfect, "and software for purposes of entertainment/study, data processing, etc. sold to the general public," bundled software, and some customized software from withholding tax.[158]

On a superficial level, the New Rules regarding software taxation are more liberal than their predecessors, insofar as they drop express "know-how" distinctions between high-end and low-end software programs and the requirement that software be domestically producible.[159] Nonetheless, several problems remain. First, the New Rules' description of software exempted from withholding tax as "sold to the general public," "without a separate license agreement," and the like, is suggestive of the former limitations with respect to high-end programs and software that could not be produced in Korea.[160] The practical result of this language may be that all but the most basic packaged software, even if purchased exclusively for home or business use, is excluded from the "shrink-wrap" exception. Software that

155. Baik & Choi, *supra* note 57, at 12; Gary D. Sprague, *Memorandum Re: New Regulations on Software Revenue Characterization* 1 (Oct. 21, 1994) (addendum on Corporate Tax Basic Rules § 6-1-13-55 (Aug. 1, 1994), unofficial translation, on file with THE HASTINGS LAW JOURNAL) [hereinafter Sprague, *New Regulations*] (Payments for Importing Software to Foreign Legal Entities).

156. Baik & Choi, *supra* note 57, at 12.

157. Sprague, *New Regulations*, *supra* note 155.

158. *Id.*

159. *Id.* at 1-2.

160. *Id.*

does not qualify for "shrink-wrap" status is likely to be taxed under the provision covering software that contains non-public technical information "essential for industrial reproduction of other products or production process," even where the end-user is granted no right to commercially exploit the underlying copyright.[161] To the extent the New Rules allow taxation of revenue from all but the most basic software transactions (and sometimes even those), they are inconsistent with both the OECD Guidelines and internationally accepted standards.[162]

Second, the New Rules still appear to subject both LAN network and site licensing transactions to withholding taxation, under the provision covering software whose price "is determined on the basis of the place, type of end users, frequency, productivity per period of use of the software, or the amount of products manufactured or information processed by such software."[163] The New Rules thus fail to distinguish between transactions involving a transfer of the right to exploit the underlying copyright, which may be taxed, and transactions that are only in the copyrighted article, which should not be taxed.

Conclusion

There are several steps the Korean government can take to bring itself in line with international standards for software taxation and the free trade principles espoused by the GATT and WTO Agreement. With respect to customs valuation, the Korean government has recently revealed plans to revise the tariff rate for computer software from eight percent to zero percent as early as January 1996.[164] This change will make software a duty free item in Korea, as it is in most other developed nations.[165] However, while a reduction to a zero percent rate will be beneficial to importers, and is clearly a step in the

161. Baik & Choi, *supra* note 57, at 15. This provision has already been broadly interpreted in the field to include certain application software and industry-specific software. *Id.*

162. See Sprague, *New Tax Guidelines*, *supra* note 143, at 12 ("Korea's application of its international tax rules notoriously has violated internationally accepted understandings of the meaning of tax treaties. Assessing withholding tax on packaged software revenue also is contrary to the stated OECD position on this issue.").

163. Sprague, *New Regulations*, *supra* note 155.

164. *See Starting in January Next Year, Tariffs to be Abolished on Imported Software—Intended to Lift Cost Burden that has been Assessed on Development of New Software Products*, CHOSUN DAILY NEWSPAPER, May 19, 1995 (unofficial translation, on file with the HASTINGS LAW JOURNAL); *Government Pursuing Zero-Tariff for Imported Software, Indicating that Sufficient Tax Revenue has been Collected—Expected to be Finally Settled Next Month*, SEOUL ECONOMIC DAILY, May 30, 1995 (unofficial translation, on file with the HASTINGS LAW JOURNAL).

165. See *supra* notes 55 & 56 and accompanying text.

right direction, it fails to resolve the underlying valuation problem.[166] Importers will presumably still be required to report software values on customs declarations, and may remain subject to penalties for incomplete or incorrect entries based on their ignorance of Korea's valuation policy.[167] More importantly, there is no sign that the government plans to drop its prosecution of companies like Computer Associates and its Korean-American manager for failing to comply with a valuation policy of which that they were not aware. Indeed, if Korea continues to pursue retroactive actions for purported customs violations that pre-date the enactment of the revised tariff schedule, other companies may find their operations similarly jeopardized. Lastly, given Korea's track record with respect to import procedures, there is no indication that the new duty-free requirement will be consistently and fairly implemented. In the absence of clear guidelines concerning valuation, it is entirely possible that lower level customs officials will arbitrarily exercise discretion in levying tariffs or imposing penalties on software importers. One need only look at the example of Japan, which encountered strikingly similar difficulties in the mid 1980s.[168]

The above problems can be resolved in a number of ways. First, the Korean government should publish a ruling clearly setting forth its policy with respect to the valuation of software for customs purposes. Ideally, this ruling would establish that software data content is excluded from the computation of dutiable transaction value, and that importers need only declare the value of carrier media on which such data is stored.[169] This would bring Korea's policy into alignment with international standards for the customs valuation of software. Alternatively, should Korea reject such a change, the government should at a minimum provide the business community with transparent notice of its position, so that importers can adjust their practices accordingly. Where possible, customs should cooperate with importers to resolve

166. Korea's consideration of a tariff reduction plan may well be a band-aid measure designed to quell recent political pressure by members of Congress and the Office of the United States Trade Representative. By making software duty free, the Korean government may be trying to please the American government and American industries without acknowledging that it lacks a transparent valuation policy and that past actions against importers were, in fact, both arbitrary and unfair.

167. Theoretically, they may also be penalized if their estimates of the value of software data are considered incorrect.

168. *See* Robertson, *supra* note 48 (discussing lower level Japanese customs agents' arbitrary and inconsistent implementation of new regulations providing for the duty-free import of software).

169. As a corollary to this, Customs authorities should also issue new directives to lower level officials clearly setting forth the procedures to be implemented. This will avoid the risk of arbitrary and discriminatory application of the law, which occurred in Japan. *See* Robertson, *supra* note 48.

remaining ambiguities and to avoid the unnecessary imposition of penalties. Lastly, Korean Customs should not take any retroactive civil or criminal action, and should cease all present actions, against importers for acts allegedly committed prior to the date of publication of notice of Korea's software policies.

Korea must also address its current position on software taxation. The Korean taxing authority, the K-NTA, should cease levying withholding taxes upon transfers of pre-packaged software that prohibit exploitation of the underlying copyright for commercial purposes, irrespective of the level of sophistication of such software, whether or not it can be produced domestically, or whether it is sold to the general public, a corporation, or a government entity. The K-NTA should also exempt payments made in connection with site-license or network transactions from taxation, to the extent that they involve home or business use only and do not reflect a transfer of the right to commercially exploit the software copyright. The Korean government has formally pledged to follow the OECD guidelines concerning international taxation,[170] which generally characterize such transactions as sales that are not subject to withholding tax.[171] Moreover, there is no basis in the OECD Convention for distinguishing, as current Korean guidelines do, between high-end and low-end software products, or products that are "essential for industrial reproduction of other products or production process."[172] Such distinctions are arbitrary and likely to result in inconsistent and discriminatory enforcement of the tax laws in the field.

As stated earlier, however, it is recommended that the United States formally adopt a position with regard to the withholding tax question before requesting any significant concessions from the Korean government in its treatment of software revenue. While the National Office of the IRS has not yet issued any formal ruling on revenue characterization, the actions of IRS agents in the field suggest that it views income from pre-packaged software transactions as business profits from the sale of goods.[173] Ironically, for a company that does business abroad, this characterization can have the deleterious effect of eliminating foreign source income tax credits that it would have received for paying withholding taxes to foreign governments.[174] Indeed, IRS agents have begun to disallow such credits on the ground

170. *See supra* note 142.

171. *See supra* notes 137 & 139.

172. Sprague, *New Regulations*, *supra* note 155; *see also OECD Model Tax Convention Commentary*, *supra* note 97, at ¶¶ 12 & 14, C(12)-5.

173. Sprague, *Current International Tax Problems*, *supra* note 95, at 3.

174. Sprague, *Current International Tax Problems*, *supra* note 95, at 3. Companies lose the foreign tax credit because only royalty income derived from licensing a software copyright abroad qualifies as foreign source income. *Id.*

that companies should not have to pay foreign withholding taxes on pre-packaged software,[175] suggesting that unless the companies actively contest imposition of the tax by the foreign taxing authority, their payment is considered "voluntary" and is non-creditable in the U.S.[176] Thus, unilateral characterization by the IRS of pre-packaged software transactions as sales may have the unfair result of increasing the overall tax burden for software makers who do business in countries like Korea, that still impose withholding taxes on such transactions. This underscores the need for foreign taxing authorities such as the K-NTA to characterize software transfers in a manner consistent with that of the IRS. Not only would uniform treatment be beneficial for U.S. software interests, but it would also be fair, due to the fact that foreign companies (including Korean software makers) exporting software to the U.S. will rarely have to pay withholding taxes if the U.S. formally adopts the "sale" characterization.

Clearly, none of the aforementioned changes in policy are likely to occur in Korea absent pressure from the United States and other trading partners. With respect to Korea's transaction-based software valuation policy, though the U.S. government has made some effort to address the concerns of American software manufacturers, more action is necessary. Immediate political pressure on both the valuation and withholding tax issues would be particularly appropriate given the Korean government's current reconsideration of its software tariff schedule and its bid to join the OECD in 1996.[177] In addition, the United States should consider initiating action under the Special 301 provisions of federal law if it is unable to reach a reasonable settlement of these issues. Section 301 of the Trade Act of 1974, as amended, grants the President "broad authority to retaliate against 'unreasonable' and 'unjustifiable' acts, policies, or practices by foreign countries which affect U.S. commerce," as brought to the attention of the Trade Representative's office by interested parties.[178] Included within the definition of "unreasonable" acts are discriminatory taxes levied against U.S. products abroad.[179]

175. *Id.*; *see also* Sprague, *New Tax Guidelines*, *supra* note 143, at 12 (some U.S. officials have stated that they will not allow a foreign tax credit to companies that fail to first seek tax relief under the U.S. Korea tax treaty).

176. Sprague, *Current International Tax Problems*, *supra* note 95, at 4.

177. *See* Glain, *U.S. Trade Dispute Simmers with Korea*, *supra* note 4 (stating that "a public row over trade will do little to help Korea's bid to join the [OECD]").

178. 1 PETER BUCK FELLER, U.S. CUSTOMS AND INTERNATIONAL TRADE GUIDE § 19.01[1], at 19-2.

179. *Id.*